and thus, price cap rates.[74] Given that the FCC has failed to prescribe procedures to allocate the common costs of facilities used to provide video and telephone services over the same network, price cap LECs have the incentive and ability to include video (or cable) construction costs as telephone service costs in order to manipulate the true level of the LEC's X-Factor and, thus, reduce the downward pressure on price cap rates.

Price cap LECs have insisted that they cannot raise prices of regulated telephone services to subsidize rates of competitive services that are offered over the same network.[75] In theory, that claim should be true. Price cap rates should be set without regard to LECs' operating costs, depreciation expenses or capital investment levels.[76] In practice, however, the FCC's price cap framework has not decoupled prices from costs.[77] In fact, the Commission has tentatively adopted price cap indexation formulas that are explicitly based on estimates of how the unit costs of the telephone services behave relative to general

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[74] See generally Price Cap Performance Review for Local Carriers, CC Docket No. 94-1, AT&T Comments, Appendix B at 3-21 (filed Jan. 11, 1996). See also Amendment to The Bell Atlantic Telephone Companies - Tariff FCC No. 10, Video Dialtone Service, Transmittal Nos. 741, 786 (Amended) CC Docket No. 95-145, NCTA Opposition to Direct Case, Declaration of Leland L. Johnson at 31-34.

[75] See, e.g., USTA Comments at 38-40. See also, Telephone Company-Cable Television Cross-Ownership Rules, Sections 63.54-63.58, CC Docket No. 87-266, GTE Supplemental Comments on Fourth Further Notice of Proposed Rulemaking at 11-12 (filed April 24, 1995); Pacific Supplemental Comments on Fourth Further Notice of Proposed Rulemaking at 4-5 (filed April 24, 1995).

[76] See J. Thorne, P. Huber, M. Kellogg, Federal Broadband Law at 411 (1995) ("Under pure price-cap regulation, it does not matter where costs are allocated; the price of regulated service is set without reference to costs.").

[77] See supra, n.74.

inflation.[78] Thus, price cap LECs may have the incentive to shift costs that have not experienced the historic productivity rates enjoyed by telephony services into the indexation formula. By doing so, they can improperly reduce the price cap LECs' productivity factor and, in turn, overstate price cap rates charged to customers of regulated telephone service.

As the FCC has previously recognized, LECs have strong incentives to shift costs from competitive video services -- such as a video dialtone and similar services -- to regulated telephone service.[79] Even though video dialtone regulations have been repealed by the 1996 Act,[80] and LECs have opted to deploy video networks in numerous ways,[81] incentives for cross-subsidization have not changed. Price cap LECs, whether using MMDS, OVS, DBS, LMDS, or integrated cable systems, remain the new entrants in the video marketplace with powerful economic assets. They have every incentive to gain a competitive edge in the marketplace by whatever means its takes. Their motivations remain the same -- to set prices as low as possible to gain market share as quickly as possible.

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[78] Fourth NPRM at ¶¶ 13, 22-40.

[79] See Video Dialtone Reconsideration Order, 10 FCC Rcd at 344.

[80] See Pub. L. No. 104-104, §302(b)(3), 110 Stat. 56 (1996). Video dialtone systems approved by to the date of enactment need not be terminated. Id.

[81] Pacific Bell, which has spent nearly $100 million on video dialtone construction in Los Angeles alone, appears that it now will provide video programming to subscribers as a radio-based multi-channel video programming distributor, at least in the short-term. A. Harmon, "PacBell Pulls Plug on Vaunted High-Tech Plan," Los Angeles Times, Part A at 1 (Jan. 26, 1996). Bell Atlantic recently has deployed a 384-channel video dialtone network in Dover Township, New Jersey. The Southern New England Telephone Company, on the other hand, has scrapped its state-wide video dialtone plans and has opted to seek a 15-year state-wide franchise to provide cable service throughout Connecticut.

As CCTA has observed in earlier comments in this docket, the Commission's failure to prescribe cost allocation procedures to segregate the common costs and overhead of providing video and telephone services over the same facilities has increased the risk of anticompetitive cross-subsidization.[82] In the video dialtone context, CCTA asked that the Commission determine "which costs are truly the consequences of a carrier's decision to provide video dialtone service" in order to set properly video dialtone rates above the cost of providing the service.[83] While the 1996 Act enables LECs, at their election, to offer video programming over their own facilities in ways previously unavailable, it does not authorize them to subsidize their video activities -- whatever they may be -- at the expense of telephone ratepayers.

Although the FCC has generally changed its regulatory methodology from traditional rate of return regulation to price cap regulation, it has retained the central goal of ensuring that consumers of LEC regulated telephone service pay just, reasonable and non-discriminatory rates.[84] Today, the potential for anticompetitive cross-subsidization is very real, as record evidence suggests that the commingling of video costs with telephony service

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[82] See, e.g., Price Cap Performance Review for Local Exchange Carriers, Treatment of Video Dialtone Service Under Price Cap Regulation, CCTA Comments at 12-14 (filed April 17, 1995).

[83] Id.

[84] See First Report and Order, 10 FCC Rcd at 8966.

costs will negatively affect price cap rates.[85] Moreover, a NARUC audit of Pacific Bell's performance under price caps in California from 1990-1994 demonstrated that Pacific Bell improperly cross-subsidized hundreds of millions of dollars of investment and expense in competitive broadband development.[86] Similarly, as noted above, some LECs continue to justify installation and construction of new multi-use networks on the basis of the alleged significant cost advantages the network will provide for telephone service.[87] In the absence of basic cost allocation decisions, the FCC's price cap regulation may not yield rates that are economically meaningful because, having been infected by non-telephony costs, they will not reflect the full extent to which changes in LECs' unit costs have been below the level of changes in the economy as a whole.

The only truly effective means for achieving the Commission's objective -- ensuring that regulated telephone service rates are just, reasonable and nondiscriminatory -- is the economically correct assignment of the underlying broadband network costs to the video

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[85] See Price Cap Performance Review for Local Exchange Carriers; Treatment of Video Dialtone Services Under Price Cap Regulation, CC Docket No. 94-1, Second Report and Order and Third Further Notice of Proposed Rulemaking, 10 FCC Rcd 11098, 11102 (1995) ("In our view, the record in this proceeding does not demonstrate that LEC productivity gains in the provision of video dialtone service will equal or exceed historic productivity in the provision of telephony.").

[86] See Letter from CCTA to Kathleen M.H. Wallman, FCC, dated September 21, 1994, at 54 (citing National Association Regulatory Utility Commissioners, An Audit of the Affiliate Interests of the Pacific Telesis Group, July 1994).

[87] In addition to Pacific Bell, supra n.86, see also Amendment to The Bell Atlantic Telephone Companies Tariff FCC No. 10, Video Dialtone Service, Transmittal Nos. 741, 786 (Amended), CC Docket No. 95-145, Bell Atlantic Direct Case (filed Oct. 26, 1995). See also Application of SNET Personal Vision, Inc. for a Certificate of Public Convenience and Necessity to Operate a Community Antenna Television System, Connecticut Department of Public Utility Control, Docket No. 96-01-24, Testimony of Hoshang Mulla at 3 (filed Jan. 25, 1996).

services category. If the Commission is to fulfill this objective, it must commit to a fundamental and thorough examination designed to reach the critical determination that all costs incurred due to a decision to deploy a particular service should be assigned to that service. Specifically, CCTA asks that the Commission require all price cap LECs that have constructed, or intend to construct, regulated telephone service and cable, video dialtone, or open video systems over the same network to prepare and submit complete and fully documented cost studies. These studies should demonstrate not only their estimated incremental costs for cable, video dialtone or open video systems, but also the incremental costs for telephone services, the joint and common costs for video and telephony services and the method for allocating joint and common costs between these service categories. Without such cost allocation regulation, LEC telephone customers will be ill-served because LECs will have no incentive to remove from price cap rates the true economic costs attributable to the LECs' massive investment in broadband facilities to serve the video market.

CONCLUSION

For the foregoing reasons, CCTA requests that the Commission decline to adopt the proposed TFP methodology, decline to institute wide-ranging amendments to the price cap structure pending implementation of the 1996 Act, and undertake a complete review of costs using cost causation principles in order to ensure just and reasonable rates.

Respectfully submitted,

Alan J. Gardner
Jerry Yanowitz
Jeffrey Sinsheimer
CALIFORNIA CABLE TELEVISION ASSOCIATION
4341 Piedmont Avenue
Oakland, California 94611
(510) 428-2225

Donna N. Lampert
Russell C. Merbeth
James J. Valentino
MINTZ, LEVIN, COHN, FERRIS, GLOVSKY & POPEO, P.C.
701 Pennsylvania Avenue, N.W.
Suite 900
Washington, D.C. 20004-2608
(202) 434-7300

Terry Murray
Murray & Associates
227 Palm Drive
Piedmont, California 94610
(510) 597-0334
Economic Consultant

March 1, 1996

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CERTIFICATE OF SERVICE

I, Cheryl S. Flood, hereby certify that on this 1st day of March, 1996, a copy of the foregoing "Reply Comments of The California Cable Television Association" was delivered by hand or by first-class mail, postage prepaid, to each of the parties listed below.

Cheryl S. Flood

Cheryl S. Flood

*William F. Caton
Secretary
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

*Todd F. Silbergeld
Office of Commissioner Barrett
Federal Communications Commission
1919 M Street, N.W., Room 826
Washington, D.C. 20554

*John Nakahata
Office of Chairman Hundt
Federal Communications Commission
1919 M Street, N.W., Room 814
Washington, D.C. 20554

*Lauren J. Belvin
Office of Commissioner Quello
Federal Communications Commission
1919 M Street, N.W., Room 802
Washington, D.C. 20554

*James Casserly
Office of Commissioner Ness
Federal Communications Commission
1919 M Street, N.W.
Room 832
Washington, D.C. 20554

*Regina Keeney
Chief, Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W., Room 500
Washington, D.C. 20554

*Daniel Gonzalez
Office of Commissioner Chong
Federal Communications Commission
1919 M Street, N.W.
Room 844
Washington, D.C. 20554

*Kathleen B. Levitz
Deputy Bureau Chief, Policy
Common Carrier Bureau
Federal Communications Commission
Room 500
1919 M Street, N.W.
Washington, D.C. 20554

*A. Richard Metzger, Jr.
Deputy Bureau Chief
Common Carrier Bureau
Federal Communications Commission
Room 500
1919 M Street, N.W.
Washington, D.C. 20554

*Rick Lerner
Tariff Division
Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W.
Room 500
Washington, D.C. 20554

*Anna Gomez
Counsel to Bureau Chief
Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W., Room 500
Washington, D.C. 20554

*Jane Jackson
Deputy Chief
Tariff Division
Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W.
Room 500
Washington, D.C. 20554

Jim Schlicting, Chief
Tariff Division
Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W., Room 518
Washington, D.C. 20554

*David Sieradzki
Tariff Division
Common Carrier Bureau
Federal Communications Commission
Room 544
1919 M Street, N.W
Washington, D.C. 20554

*Ann Stevens, Chief
Legal Branch, Tariff Division
Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W., Room 518
Washington, D.C. 20554

*Steven Spaeth
Tariff Division
Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W.
Room 518
Washington, D.C. 20554

*Judith A. Nitsche, Chief
Tariff Review Branch
Tariff Division
Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W., Room 518
Washington, D.C. 20554

*Melissa Newman
Counsel to the Bureau Chief
Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W.
Room 500
Washington, D.C. 20554

*Laurence D. Atlas
Associate Bureau Chief
Common Carrier Bureau
Federal Communications Commission
Room 500
1919 M Street, N.W.
Washington, D.C. 20554

*ITS
2100 M Street, N.W.
Suite 140
Washington, D.C. 20037

Al Swan, Executive Director
Regulatory Division
Pacific Bell
140 New Montgomery Street
Room 1719
San Francisco, CA 94105

David L. Nicoll
National Cable Television
Association
1724 Massachusetts Avenue,N.W.
Washington, D.C. 20036

Mark Fogelman
California Public Utilities
Commission
California State Building
505 Van Ness Avenue
San Francisco, CA 94102-3298

Mark C. Rosenblum
Peter H. Jacoby
295 North Maple Avenue
Basking Ridge, NJ 07920

Jules M. Perlberg
James P. Young
1722 Eye Street, N.W.
Washington, D.C. 20006

Lucille M. Mates
John W. Bogy
140 New Montgomery Street
Room 1530A
San Francisco, CA 94105

Robert M. Lynch
Durward D. Dupre
Thomas A. Pajda
Southwestern Bell Telephone Company
One Bell Center
Room 3520
St. Louis, MO 63101

Chris Frentrup
Senior Regulatory Analyst
Federal Regulatory
MCI Telecommunications Corporation
1801 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Mary McDermott
Linda Kent
Charles D. Cosson
United States Telephone Association
1401 H Street, N.W.
Suite 600
Washington, D.C. 20005

James S. Blaszak
Levine, Blaszak, Block and Boothby
1300 Connecticut Avenue, N.W.
Washington, D.C. 20036

Richard McKenna, HQE03J36
GTE Service Corporation
P.O. Box 152092
Irving, TX 75015-2092

Gail L. Polivy
1850 M Street, N.W.
Suite 1200
Washington, D.C. 20036

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ALJ/JAR/jaw DRAFT (WP5.1) Item 2
Agenda 12/20/95

Decision **PROPOSED DECISION OF ALJ REED** (Mailed 11/20/95)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Investigation on the Commission's Own Motion Into the Second Triennial Review of the Operations and Safeguards of the Incentive-Based Regulatory Framework for Local Exchange Carriers.	I.95-05-047 (Filed May 24, 1995)

RECEIVED 11-24-95

(See Appendix A for appearances.)

INTERIM OPINION

Summary

In this decision, we reject Pacific Bell's (Pacific) proposal to eliminate the Gross Domestic Product Price Index (GDPPI) minus "X" formula of the incentive-based regulatory framework (NRF) because the evidentiary record does not support a finding that effective competition exists among Category I and II services. We decline to modify the "X" factor by decreasing it to 2% given that key components of the data underlying the submitted productivity study can not be verified. We are not persuaded that the increased competition facing certain Category II services supports the removal of the price cap formula, and the protection it provides ratepayers, from all Category II services. Finally, at this time, we decline to adopt a milestone approach, to modifying the NRF.

Background

In Decision (D.) 89-10-031, issued October 12, 1989, the Commission adopted the NRF to replace traditional cost-of-service regulation for Pacific and GTE California Incorporated

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(GTEC). To promote the Commission's articulated regulatory goals[1], the NRF joined incentives for the state's two largest local exchange carriers (LEC) with safeguards for captive ratepayers and broad-based Commission monitoring.

D.89-10-031 (The Phase II decision) further provided for a focused Commission review of the NRF in 1992. While the order specified several issues that were to be assessed in the review, it acknowledged that the possibility of unforeseen circumstances discouraged the premature delineation of what precise aspects of the framework would later be ripe for review. For the initial review, the Commission determined that the examination would not be "overly broad and all encompassing"[2], and it would not reopen the issue of whether there should be incentive-based regulation. Rather, as provided under the Phase II decision, we undertook the review as the opportunity to "evaluate the effectiveness of the chosen details and balance in the adopted regulatory framework, and to make any mid-course corrections"[3] that might be needed. D.94-06-011 was the product of our recalibration, evaluation and refinement.

The Phase II decision directed Pacific and GTEC, in the initial review, to "file applications and supporting testimony... for review of operations of the adopted... framework."[4] However, the Commission determined, at the conclusion of

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[1] The Commission defined its regulatory goals as: (1) universal service; (2) economic efficiency; (3) encouragement of technological advance; (4) financial and rate stability; (5) full utilization of the local exchange network; (6) avoidance of cross-subsidies and anticompetitive behavior; and (7) low-cost, efficient regulation.

[2] D.94-06-011, mimeo at 3.

[3] 33 CPUC 2d 43 at 203.

[4] 33 CPUC 2d 43 at 236.

Applications 92-05-002 and 92-05-004, that undertaking the NRF review through the application process diverted a substantial amount of time. We estimated that approximately 9 months of the proceeding were devoted solely to responding to the companies' original applications, developing and refining issues and revising testimony. The Commission sought to substantially reduce that time, immediately focus the parties and get the maximum amount of participation from the interested parties in the next review. Therefore, we modified the existing procedure and decided to initiate the next review of NRF by issuing an Order Instituting Investigation (OII).

In D.94-12-053, we directed the parties to meet for 90 days to attempt to negotiate, among other topics, a resolution of the issues related to NRF review and an agreement on "how and when...reform" of the NRF could be achieved.[5] We further stated that the Commission would move forward on any topics the parties were unable to settle. In order to keep the review on track, we concurrently modified Ordering Paragraph 27 of D.94-06-011 to hold that "The next review shall be initiated in May, 1995 by an [OII]." The March 31, 1995 report[6] of the parties advised the Commission that the participating parties "discussed and attempted to reach agreement on... Review of the New Regulatory Framework," but "did not reach settlement." Accordingly, on May 24, 1995, we initiated this OII and started the necessary examination integral to the framework and the future.

In the OII, the Commission directed all respondents and interested parties to file a July 19, 1995, opening statement and a August 2, 1995 reply statement of the issues they believed

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[5] D.94-12-053 at 2 and 6.

[6] Report of the Parties on Negotiations Conducted Pursuant to Interim Opinion D.94-12-053.

should be addressed in the review.[7] The OII stated that further scheduling would be set later.

On June 26, 1995, Pacific filed an "emergency petition"[8] requesting that the Commission modify the OII to specify the initial issues that the company believed should be addressed in a first phase of the proceeding. Pacific asked that the review of these initial issues be completed before January 1, 1996. The company requested that the Commission determine what level of productivity factor, if any, it should apply beginning January 1, 1996. Pacific maintained that its current 5% productivity factor was adopted only for the years 1994 and 1995. Moreover, Pacific argued that the "telecommunications market is undergoing dramatic changes that have vastly altered the environment that existed when NRF was first established in 1990." (Emergency Petition at 2.) The company asserted that expedited review was imperative to ensure that the present NRF regulatory structure would be compatible with the telecommunications market in which it will operate in 1996 and beyond.

On July 10, 1995, five parties filed responses to Pacific's petition.[9] No party objected to a bifurcation of the issues of the OII. Each party agreed that the proposed issues framed by Pacific were integral. However, the parties disagreed about which issues the Commission should consider in the initial

[7] OII, p. 4 at Ordering Paragraph (OP) 3 and OP 5.

[8] "Emergency Petition of Pacific Bell for Modification of OII 95-05-047 to Facilitate an Expeditious Review of the NRF Structure."

[9] The Communications Workers of America, AFL-CIO (CWA), the Commission's Division of Ratepayer Advocates (DRA), Citizens Telecommunications Company of California, Inc. (CTC-California), the California Telecommunications Coalition (Coalition) and GTEC filed pursuant to an Administrative Law Judge's Ruling granting Pacific's motion to shorten the time to respond to the petition.

phase and the pace under which the OII should proceed. CWA and CTC-California agreed with Pacific's request that the initial phase be expedited. DRA and the Coalition[10] strongly disagreed with the proposed expedited schedule. GTEC declared that a less immediate pace than that proposed by Pacific would be feasible if the local competition proceeding timetable remained relatively unchanged.

On July 19, 1995, the Commission granted Pacific's petition in part and modified the OII to expedite Phase I. Evidentiary hearings[11] were held on September 26-28 and October 2-3 and 5-6, 1995.[12] Concurrent briefs were filed on October 13, 1995.

Issues

In this initial phase, we have narrowed our focus to three issues which reflect the Commission's questions, the concerns of Pacific and the responses of the other parties: 1) Should GDPPI minus X (inflation minus productivity factor) in the price cap formula be modified or eliminated? 2) Should the price cap formula be applied to all Category I and Category II services, or solely to Category I services? and 3) Should

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[10] The Coalition comprises AT&T Communications of California (AT&T), Inc.; California Association of Long Distance Telephone Companies; California Cable Television Association (CCTA); California Committee for Large Telecommunications Consumers (CCLTC); California Payphone Association; ICG Access Services, Inc.; MCI Telecommunications Corp. (MCI); MFS Intelenet, Inc.; Sprint Communications Co., L.P.; Teleport Communications Group; Time Warner AxS of California, L.P.; and Toward Utility Rate Normalization (TURN). For this proceeding, CCLTC appears independent of the Coalition.

[11] The Coalition's appeal of the ALJ's August 18, 1995 scheduling ruling is denied.

[12] Pacific's September, 1995 Motion for a Protective Order is granted.

implementation of NRF modification be ordered in stages contingent on achieving milestones?

A. Should GDPPI Minus X (Inflation Minus Productivity Factor) in the Price Cap Formula be Modified or Eliminated?

Positions of the Parties

Pacific

Pacific proposes that the Commission eliminate the GDPPI minus X formula. The company maintains, through the testimony of witness Dr. Robert G. Harris (Exhibits 14 and 15), that: (1) competition in California is rapidly accelerating; (2) Pacific's competitors are strong and sophisticated; and (3) technological changes, demand composition, and regulation have greatly reduced barriers to entry. Pacific witness Dr. Richard L. Schmalensee (Exhibits 1 and 2) testified that the company's proposal, in light of the state's changing competitive environment, is economically sound.

Pacific contends that the California market has been transforming in response to changes in technology that make it easier and cheaper for competitors to enter its markets. These changes decrease entry barriers and, simultaneously, increase competition among various forms of communication. The company declares that large and small business customers, as well as more sophisticated residential users, are demanding "a different mix of services than they did in the past"[13]: voice, data, image and video applications. Pacific maintains that these customers want "packages of services and products" or "one-stop shopping," which the company, to its competitive disadvantage, is unable to provide.

Harris testified that the extent to which the demand for telecommunication services is highly concentrated among customers and classes of services facilitates targeted entry. He

[13] Brief of Pacific at 9.

stated that it also makes the company vulnerable to competitive losses. Harris noted that nearly 70% of Pacific's access lines are located in the two major metropolitan areas of Los Angeles and San Francisco, with 85% of the company's business toll revenues located in just 6% of California's land mass.[14] Further, Pacific's Centrex service serves about 11% of business telephone system lines.[15] Between 1993 and 1994, according to Dr. Harris, the competitor share of high capacity services more than doubled to 37% in San Francisco and increased by a third to 39% in Los Angeles.[16]

Dennis W. Evans attested that the rewards the Commission intended when it adopted the incentive-based regulatory framework have not materialized for Pacific, in spite of the company's highly efficient management of its operations. Mr. Evans argues that the "surrogate for competition (the price cap formula) has been rendered unnecessary by the existence of strong and growing competition."[17] He states that the three broad performance measures of operating expenses, revenues, and net income demonstrate Pacific's performance under the incentive-based regulatory approach.

From 1985 through 1989, Mr. Evans testifies, Pacific reduced its cost per average access line 5.92%, distinguishing itself with the best percentage improvement of the seven Regional Bell Operating Companies (RBOC) over this time period. Of the seven RBOCs, Pacific had the lowest total operating expense per

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[14] Exhibit 14 at 7.

[15] Id. at 14.

[16] Id.

[17] Exhibit 29 at 6.

average access line in 1994.[18] In contrast, Evans declares, Pacific experienced the lowest total revenue growth of any of the RBOCs from the end of 1989 through 1994, comparing either the percentage changes in revenues from 1989-1994 or the compound annual growth rates (CAGR) for 1989-1994.[19]

Mr. Evans included a chart, reprinted below, representing the cumulative amount by which the company's revenues have been reduced each year since the beginning of the NRF.

Incentive Regulation Revenue Reductions

Year	1990	1991	1992	1993	1994	1995	Total
Revenue Adjustment	($391M)	($114M)	($132M)	($12M)	($124M)	($232M)	($1005M)

Source: Exhibit 29 at 11.

He states that the revenue reductions illustrated reflect the impact of the introduction of incentive regulation, and include the effects of inflation, the productivity factor, and exogenous ("Z") factors. Witness Evans describes Pacific's net income performance under incentive regulation as "at best, mediocre." He observes that the deterioration in the company's financial performance caused the capital markets to react. A major credit rating company, Duff & Phelps, Evans notes that:

> "cited significant rate reductions stemming from the high productivity factor (5%), the mounting competitive pressures, the opening of the 'short-haul toll market' on January 1, 1995, and the Commission's proposed rules

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[18] Id. at 8.

[19] Id. at 10, citing S.G. Warburg & Co. Inc., Telecommunications Services Statistical Summary Regional Bell Holding Companies and GTE, p. 20 (April, 1995).

> for local competition, as reasons for the lower debt rating."[20]

Dr. Schmalensee testified that Pacific's proposal to eliminate the price cap formula would substitute targeted price protection, requiring Commission approval of price changes for all Category I services (including basic access for residential and small business customers), for the current across-the-board price reductions. He outlined three benefits of the plan. First, the proposal would let the marketplace, rather than regulation, operate for services for which competition will provide price protection and other benefits such as increased innovation.[21] Second, customers would be protected by stable prices for services facing less effective competition in the near future.[22] Third, eliminating the formula removes the economically inefficient practice of price reductions for those already below-cost Category I services.[23]

Dr. Laurits Christensen sponsored his productivity study of the telecommunications industry as the quantitative basis for Pacific's alternative proposal to modify GDPPI minus X (should the Commission reject elimination) by replacing the current 5% productivity factor with 2.1%. Dr. Christensen declares that his study's 2.1% productivity offset is based on "the long term TFP[24] growth differential between the US

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[20] Id. at 14.

[21] Exhibit 1 at 1 and 10.

[22] Id. at 1 and 24-25.

[23] Id. at 1, 26 and 28-29.

[24] Total Factor Productivity.

telephone industry and the US economy" and "will be a challenging offset for Pacific Bell."[25]

Dr. Christensen states that the price cap formula has two underlying ingredients: a measure of overall inflation, and an offset (the "X factor") to the inflation measure. In theory, the X factor embodies: (1) the expected difference between the rate of telephone industry total factor productivity growth and the rate of economy-wide total factor productivity growth; and (2) the expected difference between the rate of telephone industry input price growth and the rate of economy-wide input price growth. Dr. Christensen estimates, based on his recent study of the post-divestiture LEC industry, and the results of previous studies of telephone industry productivity,[26] that the telephone industry and economy-wide TFP growth differential is 2.1% per year.

Pacific witness Christensen asserts that, as a result of his experience analyzing other Bureau of Labor Statistics (BLS) studies, his TFP study of the LEC industry is a close approximation to the anticipated BLS study. He contends that the BLS study, when eventually issued, will be using the same data as he used in his LEC study and will use similar methods of computing TFP. He outlines seven similarities between his methodology and that of BLS, and concludes with the expectation that the results of the BLS study will be very similar to his LEC study results.[27]

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[25] Exhibit 6 at 4.

[26] Id. at 9-16 and Appendix 1.

[27] Id. at 9.

Dr. Christensen contends that the expected telephone industry and economy wide input price differential is zero[28] and, thus, should not be included in the X factor. He testifies to having recently submitted an Input Price Affidavit on behalf of the United States Telephone Association in Federal Communications Commission (FCC) Docket 94-1 that determines, on a going-forward basis, that "there is no conceptual or empirical basis for believing that LEC input prices will increase significantly more slowly than input prices for the entire US economy."[29] Dr. Christensen maintains that the result he determined holds for the full 1949-1992 period, as well as for the 1949-1984 and 1985-1992 sub-periods. He concludes that any observed short-term differences in input price growth cannot be properly construed as representing a difference in the underlying trends of input prices for the LECs and the entire U.S. economy.[30] He calculates, considering both elements, the appropriate X factor to be 2.1 percent.[31]

GTEC

GTEC proposes that the Commission eliminate the price cap formula for all Category II services, defined as either partially competitive or discretionary. The company contends that the Commission established the price cap mechanism to be a substitute for the workings of a market open to competition. Accordingly, continued use of the present formula in an environment where all the LECs' markets are open to competition

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[28] In Decision (D.) 94-06-011, the expected difference between the rate of input price growth of the two was referred to as the "W" factor.

[29] Id. at 17.

[30] Id. at 18.

[31] Exhibit 6 at 4-5.

will disadvantage the LECs. GTEC recommends that, if retained, the productivity factor should apply to Category I services and be based upon the most current measurements of TFP available, i.e., the updated Christensen study. Further, the productivity factor should be adjusted downward to compensate for the level of competition that the Commission expects will develop in California.

GTEC witness Timothy J. McCallion testified that in a competitive market the forces of competition restrain overall prices to the cost of production including a requisite rate of return.[32] The purpose of price cap regulation, he maintains, is to provide a better incentive for the LEC to operate more efficiently and to restrain monopolistic behavior in an environment where markets are not open to competition. Where markets are open to competition, he asserts, the marketplace, not regulators, should determine prices.[33]

Mr. McCallion reports that as a result of the current productivity factor, as well as other NRF related adjustments, GTEC's revenues during the period from 1992 to 1995 were reduced by $125.1 million. He states that the price cap mechanism has required the company to flow through productivity gains of approximately 25 percent since its inception in 1990.[34] McCallion further declares that GTEC cannot sustain index-related price decreases when its markets are open to competition. He insists that GTEC must be able to use the productivity gains it achieves to adjust prices in its most competitive service markets

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[32] Exhibit 27 at 10.

[33] Id. at 11.

[34] Id.

to respond to the actions of competitors who have no productivity index to control their pricing decisions.[35]

Mr. McCallion contends that regulation must reflect the practical effects of competition in a balanced way, so that the marketplace rather than the Commission determines which companies succeed and fail. He argues that a company cannot compete effectively in the long term when it is subjected to artificial restraints not placed upon its competitors.[36]

Dr. David E. M. Sappington testified that market forces must determine prices where competition exists, or the situation will encourage inefficient suppliers and dull or misdirect competitive forces.[37] He maintains that it is inappropriate to continue to impose "GDPPI minus X" regulation on incumbent "suppliers" when their markets are opened to competition. Dr. Sappington suggests, first, that markets that are open to competition are fundamentally more risky for incumbents than markets closed to competition. Further, he asserts, when the discipline of price cap formula regulation is added to competition-imposed discipline, the earnings of incumbents are placed in "double jeopardy."[38]

Dr. Sappington briefly explains the risks facing incumbents. Markets open to competition are riskier because they are subject to the varied and often unpredictable activities of competitors. Different competitors adopt different pricing and marketing strategies, and try to improve products and reduce production costs in different ways. Diverse strategies and activities produce different products, different prices, and

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[35] Id. at 12.

[36] Id.

[37] Exhibit 35 at 6-7.

[38] Id. at 7.

different cost structures. Customers, once loyal to incumbents, may also choose to purchase products and services in the newly competitive market. Consequently, customer demand and potential earnings become difficult to foretell.[39] The riskier a firm's earnings, the higher the expected earnings investors demand before they will provide capital to the firm. A reduction in the productivity factor provides a convenient means to increase expected earnings.

Dr. Sappington insists that measurement of competitors' share of the market is, overall, not an accurate gauge of either the strength or discipline of competition. He states that realized market share reflects only one dimension of a complex, multi-dimensional process. In addition, the threat of losing valued customers to competitors can provide just as much discipline for incumbents as the actual loss of these customers.[40] Thus, the absence of a pronounced market share for competitors does not necessarily reflect that potential competition is having little impact on the incumbent's performance. Instead, he recommends, the "likely impact of competition on earnings should be assessed in advance, and the asymmetric handicapping of incumbent suppliers should be reduced accordingly." Exhibit 35 at 27. Dr. Sappington specifically denounces any "benchmark" proposal recommending that the productivity factor be based on the market share achieved by competitors.

GTEC witness Dr. Gregory M. Duncan testified that he endorses both the analysis and results of the "Christensen study." He agrees with Dr. Christensen's assertion that there is no differential between local exchange carrier input prices and

[39] Id. at 8.

[40] Id. at 19.

overall United States economy input prices that needs to be reflected. He maintains that if input prices were to deviate for one sector of the economy, as suggested by a number of parties, the economy as a whole would adjust to make that deviation smaller and eventually cause it to disappear.[41]

Dr. Duncan declares that to confirm Dr. Christensen's results on input prices, he ran a simple cointegration test between the local exchange carrier input price growth series used in the study and the LEC-United States price series used in FCC CC Docket No. 94-1, Appendix F. He also performed standard Autoregressive Integrated Moving-Average (ARIMA) analyses on each of the series and the difference between the series.[42] Dr. Duncan concludes that his findings support Dr. Christensen's study and parallel tests performed by the National Economic Research Associates.

DRA

DRA recommends that there be no change to the price cap formula other than a resetting of the productivity factor. DRA urges retention of GDPPI as the measure of inflation because it is a national index, readily available, and acknowledged as a reflection of general price changes in the economy. DRA further proposes that X be reset according to the most recent study of nationwide telecommunications TFP growth, adjusted by a input price proxy and a 50 basis point stretch factor.

DRA witness Hassan Mirza testified that the Commission not only anticipated intraLATA competition in the Phase II decision but also affirmed its view of a structure where NRF and competition coexist as recently as D.95-07-050, the universal

[41] Exhibit 37 at 7-8.

[42] Id. at 9.